IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

INCOME TAX REFERENCE No.19 of 1993

For Approval and Signature:

HON'BLE MR.JUSTICE D.A.MEHTA Sd/-
and
HON'BLE MS.JUSTICE H.N.DEVANI Sd/-

==========

1. Whether Reporters of Local Papers may be allowed to see the judgements? : NO

2. To be referred to the Reporter or not? : YES

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the concerned Magistrate/Magistrates,Judge/Judges,Tribunal/Tribunals? : NO

COMMISSIONER OF INCOME TAX

Versus

HYNOUP FOOD & OIL IND. PVT.LTD

Appearance:
MR BB NAIK for Applicant No. 1
NOTICE SERVED for Respondent No. 1

CORAM : HON'BLE MR.JUSTICE D.A.MEHTA
and
HON'BLE MS.JUSTICE H.N.DEVANI

Date of decision: 10/02/2005

ORAL JUDGEMENT

(Per : HON'BLE MR.JUSTICE D.A.MEHTA)

1. The Income Tax Appellate Tribunal, Ahmedabad Bench 'A', Ahmedabad has referred the following question for the opinion of this Court under Section 256(1) of the

Income-tax Act, 1961 (the Act) at the instance of the Commissioner of Income-tax, Gujarat Central, Ahmedabad.

"1. "Whether, the Appellate Tribunal is right in law and on facts in deleting the disallowance made under section 40A(3) holding that the exceptions to that section in Rule 6DD(j) can be applied for payments which were made in the course of a business outside the books ?"

2. The Assessment Year is 1986-87 and the relevant accounting period is the year ended on 31st October 1985. The respondent - assessee originally filed return of income declaring NIL income. The same was revised declaring total income of Rs.1,65,757/-. It appears that in the said revised return net profit as per revised working was shown at Rs.11,28,863/-. The Assessing Officer disallowed a sum of Rs.43,35,715/- being the purchase price which was paid in cash in relation to the business which was detected in the course of a search conducted after the return was filed. It was admitted during course of such search proceedings that the assessee was carrying on unaccounted business which was not reflected in the regular books of accounts maintained by the assessee. The explanation of the assessee that such unaccounted transactions are always made in cash and hence, provisions of Section 40A(3) of the Act cannot apply, and alternatively the case would be governed by the exception carved out in Rule 6DD(j) of the Income Tax Rules, 1962 (the Rules) as well as Circular No.220 dated 31st May, 1977 issued by the Central Board of Direct Taxes, was rejected by the Assessing Officer holding that provisions of Section 40A(3) of the Act were mandatory and were also applicable in case of illegal business as held by Andhra Pradesh High Court in the case of S. Venkata Subba Rao Vs. Commissioner of Income Tax, [1988] 173 ITR 340 (A.P.). The contention regarding applicability of Rule 6DD(j) of the Rules was also rejected by stating that qua the same parties the assessee had made payment by cheques and hence, no exceptional or unavoidable circumstances were made out.

3. The assessee carried the matter in appeal before the CIT (Appeals) who, for the reasons stated in his order dated 29th December, 1989, confirmed the assessment order on this count. The assessee carried the matter in appeal before the Tribunal. The Tribunal, for the reasons stated in its order dated 10th February, 1992, came to the conclusion that the case of the assessee was covered by the exceptions provided in Rule 6DD(j). According to the Tribunal, in case of a business outside the books, it may or may not be illegal business and

generally speaking business outside the books is an exception. That if the intention of the law makers was to tax the income from that kind of business, then logically speaking, the law makers are to be deemed to have taken into account the difficulty in obtaining proof regarding the expenditure. The Tribunal, therefore, goes on to state "..... Therefore, while complying with the statutory requirements, we must so interpret the law that the reality of the situation is duly taken into account. Finally if the state claims a share in any income, it cannot deny to the citizen the expenditure whereby the income is earned. Therefore, we are of the view that the assessee's case would be covered by the exceptions provided in Rule 6DD(j)."

4. Mr.B.B.Naik, learned Standing counsel appearing on behalf of the applicant - Revenue, has been heard. Though served, there is no appearance on behalf of the respondent - assessee.

5. Mr.Naik vehemently assailed the reasonings adopted by the Tribunal and submitted that the approach of the Tribunal amounted to putting a premium on activities which are prohibited by law. It was submitted that admittedly the business was carried on by the assessee without incorporating the same in the books of accounts maintained by the assessee and, but for the search proceedings, the income from such business would not have come to light and could not have been assessed. He, therefore, submitted that the Tribunal had committed an error in law in holding that the case of the assessee was covered by provisions of Rule 6DD(j) of the Rules. According to Mr.Naik, even if income from an illegal business was brought to tax, for the purposes of ascertaining the correct income the deductions and allowances can be allowed only in accordance with the provisions under the Act.

6. Mr.Naik placed reliance on the following decisions :

(i) Attar Singh Gurmukh Singh Vs. Income-tax Officer, Ludhiana, [1991] 191 ITR 667 (S.C.);

(ii) S. Venkata Subba Rao Vs. Commissioner of Income-Tax, [1988] 173 ITR 340 (A.P.); and

(iii) Hasanand Pinjomal Vs. Commissioner of Income-tax, Gujarat, [1978] 112 ITR 134.

7. The facts of the case are absolutely clear. It is an accepted position on record that the petitioner Company was carrying on business and was maintaining regular books of accounts. It appears that during the course of search proceedings certain documents were seized which reflected unaccounted business transactions - admittedly in the same line of business. In the business which was not reflected in the books of accounts the transactions were in cash and after ascertaining the purchases for such business on perusal of the seized documents, the Assessing Officer has disallowed the purchase price as being hit by provisions of Section 40A(3) of the Act.

8. As to what is object of incorporating Section 40A(3) of the Act has been laid down by this Court in the case of Hasanand Pinjomal (supra) in the following words:-

> "Before entering into an analysis of the relevant statutory provisions, it would be necessary to consider the object behind the enactment of section 40A. In the course of business or profession, the assessee has to incur expenditure involving payments made from time to time to different persons under various circumstances. The legislature found from experience that the existing provisions of the Act were inadequate to deal with evasion of tax under the cloak or guise of permissible deductions and also that many payments were made with unaccounted money possessed by the assessee and deductions were claimed in respect of such payments. In order to remedy such situation, section 40A was added by the Finance Act of 1968 and it came into force with effect from April 1, 1968. While introducing the Bill in the Lok Sabha for its consideration, the Finance Minister made a speech on April 29, 1968, in which he pointed out that the provision in question was intended to serve the objective of checking tax evasion. Though the Finance Minister did not elaborate, it is obvious that the intention of the legislature in enacting section 40A(3) particularly was to ensure that payments exceeding the sum specified are made by a crossed cheque drawn on a bank or by a crossed bank draft so that it will be easier to ascertain, when deduction is claimed, whether the payment was genuine and whether it was made out of income from disclosed sources. While interpreting the provisions of this section, the

above mischief which was sought to be remedied will have to be borne in mind."
(emphasis supplied)

9. Validity of Section 40A(3) of the Act came to be challenged before the Apex Court and while holding that the said provision was not ultra vires the Apex Court laid down in the case Attar Singh Gurmukh Singh (supra) :

"..... If the payment is made by a crossed cheque drawn on a bank or a crossed bank draft, then it will be easier to ascertain, when deduction is claimed, whether the payment was genuine and whether it was out of the income from disclosed sources. In interpreting a taxing statute, the court cannot be oblivious of the proliferation of black money which is under circulation in our country. Any restraint intended to curb the chances and opportunities to use or create black money should not be regarded as curtailing the freedom of trade or business."

10. In the case of S. Venkata Subba Rao (supra), the Andhra Pradesh High Court was called upon to decide as to whether payments made by the assessee in cash to the persons from whom the assessee had purchased smuggled goods could be said to be a payment made out of the business expediency within the meaning of the second proviso to Section 40A(3) of the Act and was covered by Rule 6DD(j) of the Rules ? The Andhra Pradesh High Court has reproduced the contentions raised on behalf of the assessee at Pages 343 and 344 of the Report. In sum and substance it was contended on behalf of the assessee that where the very business carried on by the assessee is an illegal business, it was not possible to comply with the requirements of Section 40A(3) of the Act and in the very nature of things, the assessee could not be called upon to establish either the genuineness of the payment or the identity of the payee. The said contention was turned down by the High Court of Andhra Pradesh holding that provisions of Section 40A(3) were rightly invoked and the payment in question, towards purchase of smuggled goods, could not be said to be covered by Rule 6DD(j) of the Rules. The Andhra Pradesh High Court in the process laid down : "Indeed, it is not disputed by the assessee herein that the profits and gains derived by him from the illegal business carried on by him are liable to be taxed. If so, the income can be taxed only under, and in accordance with, the provisions of the Income-tax Act. Once the Act applies and the taxable income has to be determined in accordance with the provisions thereof, it

is not possible to hold that some of the provisions of the Act do not apply to the assessment of taxable income in the case of an illegal business, while some others do. In other words, we do not find it possible to draw a distinction between the several provisions of the Act, one set applying to the assessment of income arising from illegal business and the other set of provisions not applying thereto. May be that in an illegal business, like smuggling, it may not be practicable to comply with the requirements of sub-section (3) of Section 40A, but that only means that such illegal business ought not to be carried on. It is a business prohibited by law. By taxing its income, it is not legalised or validated."

11. Therefore, the legal position that emerges is : in case of an illegal business, where the income therefrom is brought to tax, provisions of Section 40A(3) of the Act and other relevant provisions would come into play and the taxable total income has to be computed in accordance with the provisions of the Act. But, while doing so, the object and the intendment of the provisions has to be borne in mind. The mischief that was sought to be remedied when the provision was enacted is that when a deduction is claimed, whether the payment was genuine and whether it was made out of income from disclosed source, should be ascertainable. In other words, the provision in question is intended to serve the objective of checking tax evasion.

12. Marginal note to Section 40(A) of the Act states "Expenses or payments not deductible in certain circumstances."

Section 40A(1) of the Act states that provisions of Section 40(A) shall have effect notwithstanding anything to the contrary contained in any other provision of the Act relating to the computation of income under the head "Profits and gains of business or profession."

Section 40A(3) reads as under :

"(3) Where the assessee incurs any expenditure in respect of which payment is made, after such date (not being later than the 31st day of March, 1969) as may be specified in this behalf by the Central Government by notification in the Official Gazette, in a sum exceeding two thousand five hundred rupees otherwise than by a crossed cheque drawn on a bank or by a crossed bank draft, such expenditure shall not be allowed as a deduction :"

Under the second proviso it is provided that no disallowance under this sub-section shall be made in case of any payment exceeding a sum of two thousand five hundred rupees unless made by a crossed cheque or bank draft, in such cases and under such circumstances as may be prescribed, having regard to the nature and extent of banking facilities available, considerations of business expediency and other relevant factors.

13. Accordingly, Rule 6DD of the Rules has been framed. It sets out cases and circumstances in which payment may be made in a sum exceeding two thousand five hundred rupees otherwise than by a crossed cheque drawn on a bank or by a crossed bank draft. Clauses (a) to (i) of the said Rule lay down various circumstances. However, Clause (j) of Rule 6DD of the Rules which is in the form of a residuary clause reads as under :-

"6DD. No disallowance under sub-section (3) of section 40A shall be made where any payment in a sum exceeding two thousand five hundred rupees is made otherwise than by a crossed cheque drawn on a bank or by a crossed bank draft in the cases and circumstances specified hereunder, namely :-

(j) in any other case, where the assessee satisfies the Income-tax Officer that the payment could not be made by a crossed cheque drawn on a bank or by a crossed bank draft--

(1) due to exceptional or unavoidable circumstances, or

(2) because payment in the manner aforesaid was not practicable, or would have caused genuine difficulty to the payee, having regard to the nature of the transaction and the necessity for expeditious settlement thereof,

and also furnishes evidence to the satisfaction of the Income-tax Officer as to the genuineness of the payment and the identity of the payee.

14. Before provision of Section 40A(3) of the Act can be invoked it is necessary to take into consideration provisions of Section 37 of the Act. Under the said

section, any expenditure (not being expenditure of the nature described in Sections 30 to 36) and not being in the nature of capital expenditure or personal expenses is allowable while computing the income chargeable under the head "Profits and gains of business or profession" provided such expenditure is laid out or expended wholly and exclusively for the purposes of the business or profession.

15. Computation of profits and gains of business or profession is provided by Sections 28 and 29 of the Act read together. Thus, the scheme of the Act, as can be seen from the aforesaid provisions is that while computing income under the head "Profits and gains of business or profession" profits and gains as per Section 28 are to be brought within the tax net, but after granting various deductions and allowances as contained in Sections 30 to 43A of the Act. In other words, in case of an expenditure, which does not fall within Sections 30 to 36, is not capital in nature and is not personal expense of the assessee, Section 37 of the Act permits deduction. The question of making any disallowance under Section 40A(3) of the Act arises only in a situation where in the first instance the expenditure in question is deductible under Section 37 of the Act. Thus, after the expenditure qualifies as aforesaid, an assessee claiming deduction of such expenditure has to establish that the said expenditure was laid out or expended wholly and exclusively for the purposes of business. In the present case, bearing in mind the aforesaid legal position which flows on a conjoint reading of various provisions as detailed hereinbefore, the facts may be appreciated.

16. Whether in the circumstances of the present case is it possible to state that the case of the assessee is governed by the exceptions carved out by Rule 6DD(j) of the Rules ? The Rule has to be read in the context of the second proviso to sub-section (3) of Section 40A of the Act whereunder a disallowance is not permissible if on consideration of business expediency an assessee is able to satisfy the Assessing Officer that he was required to make payment in cash due to exceptional or unavoidable circumstances, or because payment by a crossed cheque or bank draft was not practicable, and/or would have caused genuine difficulty to the payee, having regard to the nature of the transaction and the necessity for expeditious settlement thereof, and further furnishes evidence to the satisfaction of the Assessing Officer as to the genuineness of the payment and the identity of the payee. Thus, the position is that even if business

expediency is established by the assessee concerned, the assessee would be required to show that payment by a crossed cheque or bank draft was not possible due to exceptional or unavoidable circumstances and also furnish evidence to establish genuineness of the transaction and identity of the payee; in the second situation also, after showing business expediency the assessee would be required to establish that it was necessary to make payment in cash because either the payment by crossed cheque or bank draft was not practicable, or would have caused genuine difficulty to the payee, and such impracticability or difficulty to the payee is with regard to the nature of the transaction and the necessity for immediate settlement of the transaction, and simultaneously satisfying the Assessing Officer as to the genuineness of the payment and the identity of the payee.

17. In other words, genuineness of the payment and the identity of the payee are the first and foremost requirement. Even if business expediency gets established, in absence of evidence as to genuineness of the payment and identity of the payee, an assessee cannot seek recourse to either of the two situations laid down in clause (j) of Rule 6DD of the Rules.

18. In the present fact situation the entire order of the Tribunal nowhere reflects as to how and in what manner the assessee has established business expediency and thereafter exceptional and unavoidable circumstances; nor is there any evidence to show that payment by crossed cheque or draft was not practicable having regard to the nature of the transaction and the necessity for expeditious settlement; nor is there any evidence to show that payment by crossed cheque or draft would have caused genuine difficulty to the payee, having regard to the nature of the transaction and the necessity for expeditious settlement. The reasoning of the Tribunal, that once the business was not reflected in the regular books payment by crossed cheque or draft would not have been practicable considering the nature of the transaction loses sight of the fact that the assessee is further required to show the impracticability of mode of payment having regard to the nature of the transaction and the necessity for expeditious settlement thereof. In the present case, no such evidence is placed on record. Similarly, onus which is on an assessee to establish genuineness of the payment and the identity of the payee also remains undischarged. In these circumstances, it is not possible to accept the reasoning which is adopted by the Tribunal.

19. The Tribunal has committed an error in reading the provision of Rule 6DD(j) of the Rules when it states that the necessity of the assessee proving genuineness of the payment and the identity of the payee is not connected with sub-clause(1) of Rule 6DD(j) of the Rules and the said requirement is only while invoking sub-clause (2) of Rule 6DD(j) of the Rules. The aforesaid reasoning adopted by the Tribunal is fallacious when one considers the object with which the provision has been brought on statute book. It is necessary to bear in mind that even if an exceptional or unavoidable circumstances is pleaded, the Revenue must have data with it to verify the genuineness of the transaction and identify the recipient of the cash payment. If what the Tribunal states is correct, the entire provision is rendered otiose and that interpretation can never be placed on a provision.

20. The need to prove genuineness of the payment and the identity of the payee can be appreciated from a slightly different angle. The Revenue must be permitted to inquire and ascertain that the payment made in cash by an assessee is reflected in the accounts of the recipient payee. In other words, the cash paid by an assessee should remain in regular and legal business and banking channel. In absence of the identity of the payee it will not be possible for the department to ascertain the destination of the payment. This is, of course, subject to the genuineness of the transaction and payment being established. Therefore, Rule 6DD(j) can be applied only in cases where the genuineness of the payment is established, the payee is identified, and only then the question as to whether the payment in cash was made in exceptional or unavoidable circumstances can be examined.

21. In light of what is stated hereinbefore, it is not possible to accept the findings of the Tribunal. The Tribunal has committed an error in law in holding that the case of the assessee would be covered by the exceptions provided in Rule 6DD(j) of the Rules. The Tribunal has apparently lost sight of the distinction between an entire business which is illegal and a business which is otherwise lawful wherein the assessee resorts to unlawful means to augment his profits. In this connection the following observations made by the Apex Court may be fruitfully reproduced from the case of Maddi Venkataraman & Co. (P) Ltd. Vs. Commissioner of Income-tax, [1998] 229 ITR 534 :

" One exception to this rule which has been recognised by the courts is where the entire

> business of the assessee is illegal and that income is sought to be taxed by the Income-tax Officer then the expenditure incurred in the illegal activities will also have to be allowed as deduction. But if the business is otherwise lawful and the assessee resorts to unlawful means to augment his profits or reduce his loss, then the expenditure incurred for these unlawful activities cannot be allowed to be deducted. Even if the assessee had to pay fine or penalty because of an inadvertent infraction of law which did not involve any moral obliquity the result will be the same. Even in such cases, deduction will not be permitted of the amounts paid as penalty or fine or of the value of the goods confiscated by the statutory authority as expenditure wholly and exclusively incurred for the purposes of carrying on the trade. It has been consistently held by the English courts that fines or penalties payable for violation of law cannot be permitted as deduction under the Income-tax Act. That will be against public policy. Even though the need for making such payments arose out of trading operation the payments were not wholly and exclusively for the purpose of the trade. One can carry on his trade without violating the law. In fact, section 37 presumes that the trade will be carried on lawfully."

22. The question referred to the Court is, therefore, answered in the negative i.e. in favour of the Revenue and against the assessee.

23. The reference stands disposed of accordingly. There shall be no order as to costs.

Sd/- Sd/-

[D.A.MEHTA,J] [H.N.DEVANI,J]

* * *

'Bhavesh'